Ref.: CESR/08-671

# CESR's response to the consultation document of the Commission services on a draft proposal for a Directive/Regulation on Credit Rating Agencies.

## I. General comments

CESR acknowledges the drivers behind the Commission's proposal but still considers CESR's "Report to the European Commission" (CESR/08-277) appropriate and the most proportionate way of addressing the challenges in the credit rating industry.

In this report CESR considered that there was a strong need to take a step forward in ensuring integrity and confidence in the rating industry and encouraging the effective use of ratings by investors. CESR therefore urged the Commission to form an international CRAs standard setting and monitoring body to develop and monitor compliance with international standards in line with the steps taken by IOSCO, using full public transparency and acting in a 'name and shame' capacity to enforce compliance with these standards via market discipline.

### *1. Limited scope of the response*

This urgent response has been formulated within a very short period of time, the consultation period that started on the 31st of July 2008, being limited to a little over one month. Moreover, a cost benefit analysis/impact assessment has not been included in the consultation paper.

Within the short time period allocated, the Committee has not been in a position to formulate a detailed analysis of the individual provisions of the proposal, which have potential far-reaching consequences, and which require thorough analysis not only in terms of cost/benefit but also in terms of competition and international coherence.

This response will be limited to some of the general underlying assumptions on which the proposal is based. However, the Committee believes that a number of proposed provisions need significant revision.

The Committee's opinion relates only to the competence of the Committee members in the field of financial markets and financial products and investor protection. Therefore the Committee does not take a position on the use of credit ratings by credit institutions or insurance companies, as this is the remit respectively of CEBS and CEIOPS. Due to the short consultation period, the Committee has not been able to consult with the two other committees. It underlines however that a detailed analysis and comparison should be made of the use of credit ratings and the authorisation or registration requirements and procedures used in the regulations of credit institutions and insurance companies.

### *2. Need for international coordination*

The Committee also draws attention to the international dimension of the credit rating activity, the effects of a European decision on the markets worldwide and of decisions by other – mainly American and Japanese - regulators on the European markets. The Committee calls for the need to duly taking into account such international dimension as well as the measures already adopted in other jurisdictions with the intention to avoid inconsistencies and an un-level playing field. As appears from a first analysis, on several points the EU proposal is not aligned with the US regulation on CRAs and with the international standard setters acting within IOSCO. This will lead to

extraterritorial applications of requirements dealing with the organisation of the agencies worldwide.

### *3. Proportionality*

A general provision on proportionality (in level 1 and/or level 2) is called for, allowing taking account of the differences in dimension between the internationally active CRA and the many local agencies. A proportionality rule might also help to mitigate any possible anti-competitive consequences of the Commission's proposal.

Moreover, in general, CESR considers that the Commission should refrain from adopting any measures that might have anticompetitive consequences taking into account the oligopolistic features of the rating business.

Also questions have been raised about the proportionality and consequences in terms of barriers to entry of the requirement that third country CRAs would need to have a subsidiary/branch in the EU for the sake of getting an authorisation (Art. 3 (3)).

## II. Specific comments

The present response will be limited to three points: the scope of the proposed regulation, the substantive provisions (Title II, Chapter II) and the supervisory issues (Title III). CESR stands ready to provide its views to the Commission on the detailed provisions contained in the proposal.

### *1. The Scope (Title I)*

The proposed regulation defines the scope exclusively from the angle of its use by regulated investors (credit institutions, insurance undertakings, pension funds and UCITs). However, other investors might be exposed to ratings that have been produced by unregistered CRAs. Therefore it is useful to add an investor perspective, stating that European issuers cannot request ratings except from registered CRAs when offering their securities in the European Union. This would not oblige however all issuers to apply for a rating. It would also be useful to include a clearer definition of what a credit rating is to ensure that the scope does not catch services that should not be.

### *2. On the substantive provisions (Title II, Chapter II)*

The Committee considers that several of the substantive provisions are very detailed and may lack adaptability to existing diversity and to future developments such as market developments and new international standards. In line with the Lamfalussy approach, the Committee therefore calls for limiting the regulation to high-level principles, to be further detailed in level 2 implementing measures. Also reference should be made to the need to develop level 3 guidelines, as these will especially be necessary for taking into account the need for proportionality for smaller agencies.

As outlined above, the international dimension of the business performed by the CRAs should be accounted for. In this respect, the Committee highlights that in the proposal there are similarities and differences (e.g. article 10 (2) of the proposal) with the SEC requirements and with the IOSCO code. These differences especially relate to the formulation of the rule, to the nature of the requirement (strict rule vs. disclosure) or to its formulation (more leeway) while at least in one instance, the EU rules seems to be more flexible (art 12(3) last sentence of the proposal). Credit ratings are essentially an international matter, affecting investors all over the world. Hence, there is a strong need for an internationally harmonised set of requirements. The imposition of stricter requirements on a unilateral basis would seriously jeopardise the significance of the ratings, leading to European vs. International ratings. The efforts to harmonise that have been reached at a global level would also be undermined. Therefore the Committee recommends that before imposing different or additional requirements, efforts should be made to reach agreement with the authorities

of other major users of credit ratings. Due process and consultation would then be part of the regulatory procedure.

The Committee draws the attention to the formulation of many of the substantive requirements in terms of strict obligations to be monitored by the Competent Authorities. This approach exposes the Competent Authorities to an intensity of supervision that can possibly not be met, given the present wording of the substantive rules. This may give rise to a very considerable liability for competent authorities and a possible undesirable moral hazard. Art.12 on "rating methodologies" can be especially mentioned in this respect. In general, the goal for a potential regulation should be the supervision/monitoring of principles and processes that a CRA undertakes to generate a proper rating rather than influencing the methodology a CRA uses. Therefore the Committee advises to formulate, wherever feasible, the requirements in terms of process, rather than strict obligations, whereby the supervision would focus on whether adequate procedures or internal guidelines are in place as well as on internal control structures to ensure compliance with these procedures (e.g. art.12(1): methodologies should be "rigorous, systematic and continuous…. and based on historical experience…. and applied in a consistent manner" should be rephrased as "CRAs should adopt procedures to ensure that methodologies are ...").

More generally, some provisions might restrict the analytical independence of the CRAs for their ratings. It should be made clear that the European framework does not regulate the substance of credit ratings. CESR considers that the goal of the supervision should not be to judge individual ratings.

### *3. On the supervisory issues*

Several members recalled CESR's previous advice and declared their preference for a global solution, based on enhanced self-regulation.

Generally, the proposal does not clarify what is the nature of this supervision: is it general oversight, monitoring on the basis of the rules, or a more general type of supervision, comparable to prudential supervision? The Committee draws attention to the consequences of this choice in terms of the risks and liabilities for the supervisors involved and hence for the States for which they act.

On the supervisory structure, several lines of reasoning have been put forward. CESR members have not reached a consensus on one single approach.

Some of the approaches outlined below could be combined, to achieve on the one hand clear responsibility – as indicated by the Commission (see litt.b) - while allowing for the involvement of several competent authorities (as supported by a certain number of CESR members, see litt. a).

#### a) The Cooperative approach

Some CESR members support an approach similar to the one followed by CEBS for the recognition of ECAI under the CRD. It consists of an assessment made by a CEBS Task Force on behalf of all CEBS members, resulting in a recommendation to be endorsed by all members and leading to the registration of the rating agency as an ECAI by each of the members. This CEBS task force was open to all members and all took part in the assessment of the three main agencies, while for the other local agencies, specific arrangements among the effectively concerned members were agreed.

In this case CESR could play the role of the facilitator, serving as the single entry point, hosting the assessment procedures as undertaken by the Task Force for which it could act as secretariat, and for reporting by the Task Force to the CESR Plenary, whether initially upon registration, and on a regular basis. The registration would remain a national decision, taken by each of the CESR members, as represented in the CESR Plenary, and authorised or approved by the competent national bodies of each member. The registration would remain a national decision taken on the basis of a common position agreed by the members within CESR. The list of nationally registered CRAs could be published by CESR, indicating the members that have proceeded to registration.

The advantages of this technique are its flexibility, the use of a "single entry point" and the cooperative nature of the procedures. Although decisions will still be taken by all CESR members, ongoing "supervision" would be undertaken in a Task Force to which the CRAs would report. The Task Force would report regularly to CESR Plenary and submit decisions when needed. If a decision is not taken unanimously, it would not be applicable in the jurisdiction of the opposing member. It is considered essential that all members should be equally involved, avoiding a two speed process. However, undertaking actions on a day to day basis on the improper exercise of CRAS activities that affect a company traded on a national market should be the competence of the authority of that market.

Some members consider that the disadvantages relate to the risk of diversity of application[1], the risk of divergent assessments and hence mere national application and possible disconnection between supervision (in hands of the Task Force) and enforcement responsibility (borne by the Member State regulators). Moreover, enforcement would be left to each of the competent authorities (CAs), implying diversity in terms of injunctions, remedies and sanctions. Coordination within CESR should be necessary but will remain voluntary. National decisions would be open for review before national courts, leading to great complexity. If sanctions are imposed, "Ne bis in idem" would come into play: it has been argued that the jurisdiction that first started proceedings would have to handle the case.

The latter disadvantages could be remedied by strengthening the coordination among the CESR members, essentially for purposes of enforcement. This could be achieved by way of an MOU or a protocol among the CESR members, fixing procedures for enforcement action and defining criteria as to which authority will take the lead for a specific enforcement action when this is needed with a view of a possible judicial procedure. Criteria for the latter point could be defined in the regulation itself.

The role of CESR would be that of a facilitator: CESR would not take legal decisions, as the legal competences would remain with the CESR members. Some decisions would, however, be taken by CAs within CESR. CESR would organise the practical cooperation between CAs and contribute to convergence by adopting common views, recommendations or interpretations and by its mediation function (cf. Article 16, market abuse directive). In all these respects, the intervention of CESR would not change v.à.v. its present role. Some members consider that the day-to-day follow-up would remain a national matter: in some cases even remedies or sanctions will be essentially a national matter. However, if the violation to be sanctioned points to a more general concern, it should be taken up at the general, (i.e. CESR level).

### b) The Commission's proposal (option 1)

The Commission's proposal contains an alternative scheme consisting of allocating the supervisory competence to one single national supervisor, "the Home CA". The involvement of the other CAs ("host CA") is left open, except that they recover their national competence in case of inaction or ineffective action (art 21 (2). Art 22 outlines the procedures to be followed for CAs to recover national competence.

In this case "the Host CA" would recover competence for all matters, suspension or withdrawal of the registration excluded. Although it would maintain the residual responsibility of all CAs, the proposal would introduce one registration by the Home CA.

The proposal introduces a strong definition of competent authority, allowing for unity of action, single entry point and single rulebook. It would facilitate international contacts. In respect of the role of CESR in this process, the proposal provides that "CAs shall participate and work together constructively in the activities of CESR" (Art 19, in fine). A benefit of this structure would be the ability to define a single entry and liaison point for CRAs.

The proposal contains no criteria for defining the "home competent authority". For reasons of legal certainty, it would be useful to clearly define these criteria.

[1] This risk is somewhat mitigated by the circumstance that divergence between national rules will be limited, as the Draft Directive/Regulation provides that neither home nor host authorities may impose additional requirements on CRAs.

Apart from the case of "recovery" of competences, the proposal does not clarify the level of involvement of the Host CAs in the entire process. Although it contains elaborate provisions (art. 23 to 26) on the cooperation between CAs, it is unclear how these relate to the role of the "Home competent authority", al least in the absence of a "recovery" procedure.

According to some CESR Members, one could wonder whether a home-host approach can be applied here, as there is no clear centre of business, and some agencies would be active on a remote basis only. Additionally, those members consider that this model would lead to uncertainties as to what are the competences of each authority. Whilst this is the view of some CESR members others consider that the establishment of objective criteria could be realistically achieved to allow a single home CA to be identified with respect to specific CRAs. Some members also consider that in comparison to the cooperative approach, the ability to define ongoing, specific regulatory responsibility for supervision and enforcement is an advantage of the home-host structure as it would avoid a duplication of action and create a proportionate regime.

Some Members suggest more flexibility in the home/host approach: like in other home/host supervisory structures, the home supervisor would inform the host supervisors about the supervised entity. In case of disagreement between home and host supervisors, CESR would contribute to convergence by its mediation function.

As ratings would affect the markets of several, and in some cases all Members States, restricting, according to the "recovery procedure" the action of the other competent authorities to "inadequate measures… or persistent prejudicial action by CRAs" (see art 22,2), without any involvement in the ongoing monitoring of their action and in decision making does not fulfil the objectives of some of the CESR Members. These members argue that the home CA might be less sensitive to the impact on another Member State's market and might not share its willingness to impose sanctions.

### c) The European Agency

Within the Committee there is little support for the Commission's option 2 that would combine the establishment of a EU Agency (responsible for authorisation) with ongoing supervision by the national regulators.

Two CESR Members, while being aware of the difficulties raised, call attention to an alternative model whereby an European agency would have full authorisation and supervision powers, as this would define clear responsibilities and would create a "one-stop shop". In their view, as CESR Members do not currently have competences over CRAs, the setting up of an EU Agency would create from scratch a clear unified system for the authorisation and supervision of CRAs in the EU, avoiding the complexities and cost of other alternatives.

It is not clear however, if the said views fit with the concept of an European agency as defined in the Community texts.

According to these Members, the issue should at least be further explored.

### *4. On sanctioning powers*

The Committee reserves its right to analyse article 21 on sanctions in greater detail. A strengthening of the provisions allowing it to publish its findings would be necessary, as disclosure is likely to be the most effective enforcement measure. A reference in the text to fines would also be useful.

## III. Reliance on ratings

CESR has analysed the working document of the Commission services for consultation on "Tackling the problem of excessive reliance on ratings". CESR shares the Commission's services concerns about the possible excessive reliance on rating and welcomes the Commission's initiative to explore

possible ways forward. However, given the vagueness of the proposals included in the Commission's paper and the lack of time, CESR considers it is not possible at this stage to provide any meaningful input to the Commission.